

## Memorandum

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Subject : Doctors/SCPIE Acquisition

Date : March 21, 2008

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### I. Introduction

The California Department of Insurance (CDI) requested the assistance of this office in analyzing the competitive impact of the proposed combination of two large California domiciled medical malpractice insurers. The Doctor's Insurance Company (Doctors) seeks to acquire SCPIE Indemnity Company (SCPIE) for the total purchase price of \$280,743,143 (\$28 per share for SCPIE's 9,575,333 outstanding shares). After the acquisition, SCPIE will be a wholly-owned indirect subsidiary of Doctors.

An initial review by CDI statisticians indicates that Doctor's post-acquisition medical malpractice market share would be approximately 45.3%, up from an estimated 25.78%, making it the largest medical malpractice insurer in this state. One of the CDI's statutory criteria for reviewing this transaction is whether the transaction would "substantially lessen competition in insurance in this state or create a monopoly." CIC section 1215.2(d)(2). CDI requests an analysis of competitive impact under section 1215.2(d)(2).

In determining whether this acquisition would substantially lessen competition in the market for medical malpractice insurance, we use the analytical framework of the National Association of Attorneys General Horizontal Merger Guidelines ("NAAG Guidelines").<sup>1</sup> Based on documents obtained from the parties, public information and interviews with third parties in the medical malpractice insurance market, this office concludes that this acquisition would not significantly harm competition for medical malpractice insurance in California.<sup>2</sup>

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<sup>1</sup> The NAAG Guidelines were issued in 1987, revised in 1992. They explain the general enforcement policy of the 55 state and territorial Attorneys General and the Corporation Counsel of the District of Columbia concerning horizontal mergers and acquisitions. The NAAG Guidelines also attempt to harmonize with the Horizontal Merger Guidelines issued jointly by the U.S. Department of Justice and the Federal Trade Commission.

<sup>2</sup> Both parties submitted Hart-Scott-Rodino Act (HSR) filings in late 2007; the comment period expired without action by the U.S. Department of Justice (USDOJ) or the Federal Trade Commission (FTC).

## II. Background

Doctors is headquartered in Napa, California and provides medical malpractice insurance for approximately 10,822 physicians in this state. SCPIE is headquartered in Los Angeles, California and provides insurance for approximately 8,024 physicians in California.

Sellers of insurance, such as Doctors and SCPIE, are regulated by the California Department of Insurance (CDI). Under the state's regulatory scheme, medical malpractice insurance companies must submit rating plans, rate changes, and various policies to the CDI for prior approval, and the insurers have the burden of showing that the requested rate changes are justified.<sup>3</sup> Also, California's rate making process for insurance companies is public and interested parties have the right to object to the proposed changes.

## III. Analysis of the Doctors-SCPIE Acquisition

### A. Market Share and Concentration

In evaluating mergers between competitors, we consider both the post-merger market concentration and the increase in concentration resulting from the merger.<sup>4</sup> A measure of concentration in merger analysis is the Herfindahl-Hirschman Index ("HHI"). The HHI is calculated by summing the squares of the individual market shares of all market participants. Generally, post-merger HHIs above 1800 in a particular market are considered highly concentrated, and it is presumed, under the NAAG Guidelines, that mergers producing an increase in HHI of more than 50 points are likely to create or enhance market power or facilitate its exercise.<sup>5</sup>

An initial review of this acquisition by CDI statisticians indicates the pre-merger HHI index at approximately 1936; post-merger, the total index would be 2942. At this level, the acquisition could have adverse competitive consequences. However, caution must be used in relying on HHI numbers alone to assess competitive effects in this case because such data excludes alternatives to traditional medical malpractice insurance products such as self-insurance and "alternative risk vehicles."<sup>6</sup>

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<sup>3</sup> See California Insurance Code section 1861.05.

<sup>4</sup> See NAAG Guidelines section 3.

<sup>5</sup> Id.

<sup>6</sup> Kaiser Permanente is an example of an entity that self-insure for medical malpractice; Cooperative of American Physicians, Inc. ("CAP-MPT") is one such "alternative risk vehicle"

Furthermore, market share and concentration data provide only the starting point in determining whether a merger/acquisition is likely to substantially lessen competition. Key in determining the competitive effects of a merger is the proper identification of the relevant market in which to assess the merger's impact, an examination of competitive alternatives available to consumers (in this case, physicians), and the existence of barriers to entry into the relevant market.

#### B. Product and Geographic Market Definition

A merger's likely competitive effects must be evaluated within the context of properly defined markets—i.e., markets that could be subject to the exercise of market power.<sup>7</sup> The NAAG Guidelines states that “the reasonable delineation of these market boundaries is critical to realizing the objectives of the guidelines and the antitrust laws.”<sup>8</sup> A key element of this analysis involves the proper identification of all competing firms, including those that offer alternatives to Doctors' and SCPIE's products, from the point of view of consumers of the merging firms' products, in this case, physicians.

Here, the relevant market in which to assess' the competitive effects of this merger is the market for medical malpractice insurance and/or alternatives to medical malpractice insurance available to physicians in California. This market encompasses firms that operate outside of the state, since physicians in California are not limited to firms within the state for their medical malpractice insurance needs.

#### C. Viable Competitive Alternatives for Physicians

Data obtained from the parties, public sources and third party interviews show a large number of companies are competing in the medical malpractice insurance market in California. They include large multi-specialty insurance companies that operate on a national basis and

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that is not licensed by the CDI, but competes in the medical malpractice insurance market nationwide and in California. It is estimated that CAP-MPT has roughly 10% share of the medical malpractice market in California. The Attorney General has no opinion whether market shares based on physicians served in California is the appropriate measure of market shares for purposes of calculating HHIs in this case.

<sup>7</sup> See NAAG Guidelines section 3.

<sup>8</sup> Id.

“alternative risk vehicles,” the largest of which is CAP-MPT.<sup>9</sup> In addition, large doctors’ groups (usually groups of 100 or more doctors) do self-insure or consider self-insurance as a viable alternative to traditional medical malpractice insurance.

Furthermore, interviews with insurance brokers and physicians show that the environment in which doctors, particularly doctors’ groups, choose medical malpractice insurance resembles a bid market in which requests for proposals (“RFPs”) are sent out to several companies at once; each proposal is in turn closely evaluated based such factors as price, reputation, claims handling, and A.M. Best ratings<sup>10</sup>. The contracts usually expire after one year, in which case they are normally renewed if the doctors are pleased with the services rendered. Oftentimes, physicians and their brokers reevaluate every year their medical malpractice insurance carriers; and the evidence obtained from physician interviews, public sources, and internal documents from the parties, suggests that there remains strong competitive alternatives to Doctors and SCPIE post-merger.

#### D. Barriers to Entry

The next question in merger analysis involves evaluating ease of entry in the relevant market, or the existence of barriers that could hamper entry.<sup>11</sup> Here, we find entry barriers to be relatively low: to compete in California, an insurance company must only obtain licensing with CDI.<sup>12</sup> Out-of-state insurers, backed by the financial resources of large parent corporations, presently operate in California and can easily expand their operations in this state in response to anticompetitive behavior by Doctors-SCPIE post-merger.<sup>13</sup>

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<sup>9</sup> CAP-MPT is not an insurance company and is thus not regulated by CDI. Nevertheless, the company competes with medical malpractice insurance companies. It is not necessary, from an antitrust perspective, for competitors to offer identical products. The key question whether consumers view the products as substitutes. Here, the facts show that physicians view CAP-MPT as a competitive alternative to medical malpractice insurance offered by insurance companies.

<sup>10</sup> A.M. Best’s rating reflects its opinion of an insurance company’s financial strength. An A.M. Best rating of at least A- is important to insurance brokers in the industry to recommend to their clients. SCPIE currently has a B+ rating, currently up from a B.

<sup>11</sup> See NAAG Guidelines section 5.1.

<sup>12</sup> Alternative risk vehicles such as CAP-MPT are not licensed by CDI but by the Department of Corporations.

<sup>13</sup> It has been suggested that new entrants into the California market have only managed to attain small market shares, despite the large financial resources of parent companies, as

Furthermore, this is an industry in which insurance brokers seem to play an increasingly important role in facilitating entry, not only of less well-known A.M. Best A-rated insurers, but some are also counseling physician groups on the viability of self-insurance.

#### IV. Conclusion

Based on the above, we do not believe that Doctors' acquisition of SCPIE would "substantially lessen competition in insurance in this state or create a monopoly" in California.<sup>14</sup> Our investigation has concluded that post-merger, there remains to be some strong viable alternatives in the medical malpractice insurance market for physicians in this state.

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probative of high entry barriers in this market. However, our investigation has found that relatively low market shares of some large multi-specialty insurance companies may have more to do with internal strategic decision-making and California's insurance regulatory environment, which has effectively kept a downward pressure on medical malpractice premiums in this state, than high entry barriers.

<sup>14</sup> We did not analyze possible efficiencies that could result from this acquisition. The NAAG Guidelines do not find empirical support for the assertion that mergers of sufficient size to raise antitrust concerns will on average result in substantial efficiencies. Our analysis focused on the ability of a combined Doctors-SCPIE to exercise market power or otherwise engage in anticompetitive behavior.